DOW THEORY LETTERS INC.

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36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

September 1, 1967 Letter 368

THE CRACKS APPEAR: (1) On August 25 the D-J Utility Average broke to a new low for 1967.

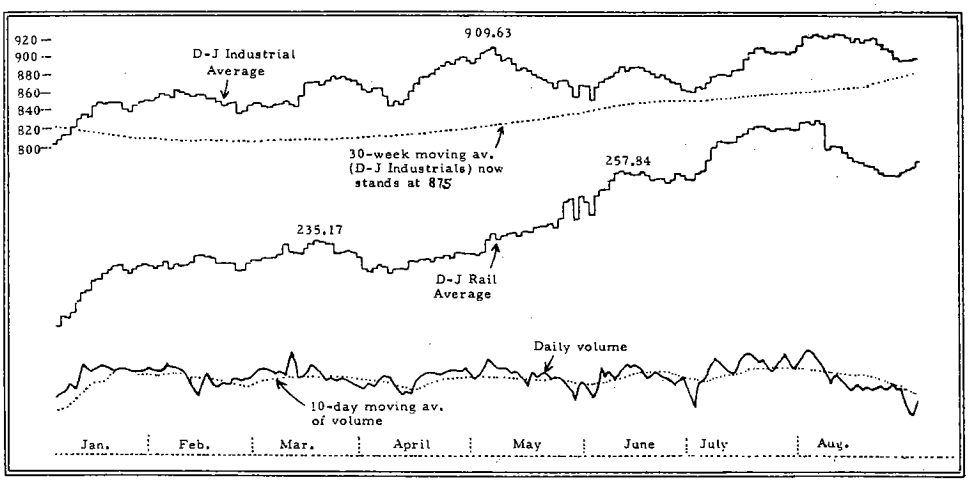
(2) On August 25 the D-J 40-Bond Average broke to its lowest level since 1933, with the yield on the 40-Bonds rising to an incredible 6.01%.

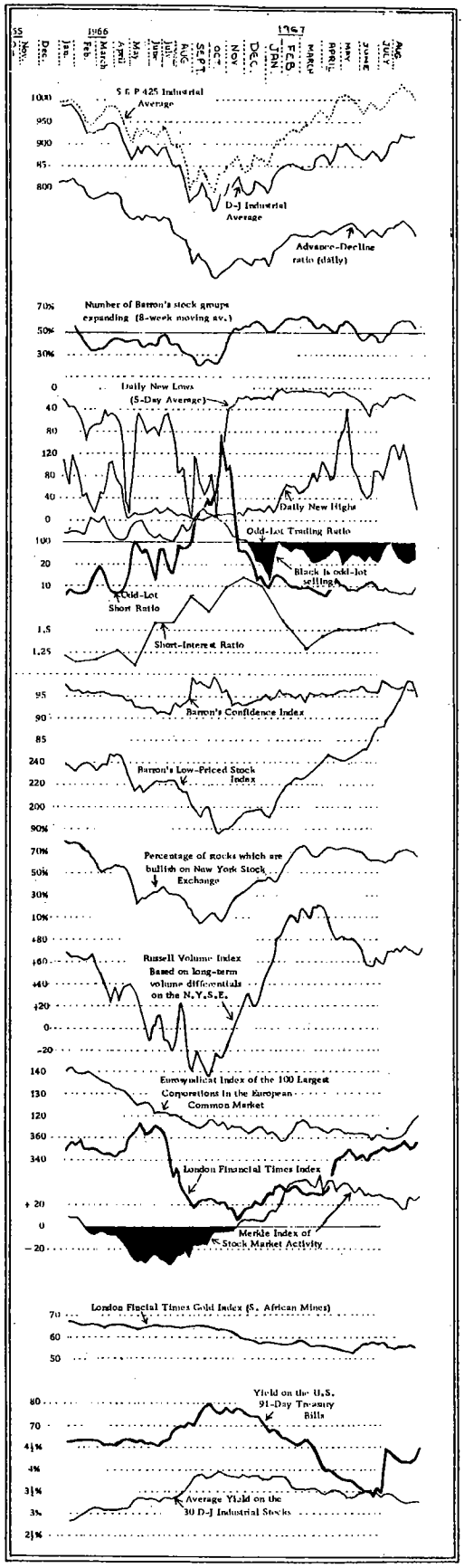
(3) On August 29 the yield on 91-day Treasury bills rose to a new high for the year at 4.49%, while the bellwether 4¼ of 1987-92 Treasury bonds sank to an historic low of 87.2.

THE MARKET: If it was not so ominous, it would be the most titillating financial dilemma of the decade. President Johnson wants the economy to boom so that (among other things) he can put through his 10% surtax and thereby cut down the coming huge budget deficit. And some of the statistics coming through tend to back up LBJ's hopes of an economic boom. Personal income increased by $4.5 billion in July, retail sales gained nearly $300 million in July, Industrial production rose a full point in July, housing starts rose 11% in July. The President will argue that the economy is rosy and easily able to absorb a tax increase.

There's only one little catch. Economic statistics must necessarily deal with what has happened. Or, as the old Wall Street adage goes, "All facts are history." Only the stock market deals with future expectations, and it is now rather obvious that the stock market is looking "toppy." In this writer's opinion, the market is running headlong into major trouble, and I would say that my studies indicate that the big speculative explosion (upward reaction) of 1966-67 is breathing its last. When the forces which run counter to the primary trend exhaust themselves, the primary trend reasserts itself, usually with a vengeance. I believe that the market is rapidly moving into the deadly grip of the bear.

In the last Letter I discussed the so-called "bull signal" of early August. This is the signal about which so many Wall Street analysts waxed poetic—but which I considered false. In fact, I considered this signal to be a final deceptive trick provided by this ebbing rally in a primary bear market. In Letters written during late 1966 I warned readers about what to expect during the second phase of a bear




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurovalue Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

market. The second phase is almost always the most treacherous one, and it is during this phase that one can expect any number of foolers. Thus, I place the powerful 1966-67 rally in the "fooler" class; it was explosively speculative, deceptive in that the quality stocks were not a factor in the rise, and it ended with a deceptive false bull signal. A few weeks after the fake signal the market was on its way down again.

QUOTES FROM THE SERVICES: Dysart's Trendway Service (August 25): "Since our 'Red Signal' bulletin dated Aug. 21, 1967, announcing the inception of what we believe will eventually prove to be a Major Bear Market, weakness of prices has continued on subsiding volume. It would appear that many people have decided to hold stocks rather than sell them and accept dollars of dubious value."

DAHL'S APPROACH (Aug. 25): "In this writer's opinion, evidence is beginning to develop that the Aug. 9th high will become the top of the big market rise since Oct., 1966. So far, the decline appears due to lack of buying demand rather than from selling pressure. Should the decline continue, many investors with good profits will become concerned and sell to protect their profits."

INVESTMENT INDICATORS (Aug. 25): "Our 35 regular and reliable long-term indicators are maintaining a strong pattern with no signs of immediate vulnerability to the market cycle. A few of the backbone indicators, like the Short Interest, Odd Lot Index, Odd Lot Short Sales, and Net Free Reserves of the banking system, are either improving or holding."

DREW ODD LOT STUDIES (Aug. 19): "The market has shown some mild deterioration, but this has not been so marked as to indicate an important decline is likely at this point. However, the upside potential for the Average price level appears limited and longer-term risks loom large. For the time being, we should expect a relatively narrow area of Average price fluctuations."

SCHAEFER'S DOW THEORY TRADER (Aug. 26): "At Friday's close we have an almost perfect set-up for a severe drop in the stock market during the next several months to come. Trading volume has been at all-time high records on the bear market rally which came during the first 8 months of 1967, the majority of services and analysts have been entirely too bullish (which has been a disservice to many investors), the crowd has been buying stocks with its eyes closed— and the net result of all of this is a situation wherein the public probably will be hurt badly."

If this is the end of the 1966-67 (upward) correction, then by definition the primary bear market is in force again. We should remember that ordinarily, secondary reactions during bull or bear markets last approximately three weeks to three months while tending to correct one-third to two-thirds of the primary movement. The upward correction which started in October, 1966, lasted 10 months and retraced about two-thirds of the Industrial losses, over 100% of the Rail losses. This means that the correction lasted far longer than the average and it retraced a good deal more than the average. The advance of 1966-67 was far more speculative than the average and, in fact, it was one of the most speculative in history.

I believe that the upward correction of 1966-67 was so lengthy and so speculative because of the Federal Reserve Board's policy of flooding the nation with money. This amounted to manipulation of the primary (bearish) trend. As a rule, when the primary trend is "held back" or manipulated, then once it takes hold again it makes up for lost time. Because the Government held back the primary bear forces during late 1966 and most of 1967, I would expect the action during the coming resumption of the bear market to be drastic on the downside. I would go so far as to say that it would not surprise me to see that Average break to new lows (below the 1966 lows) by the end of this year.

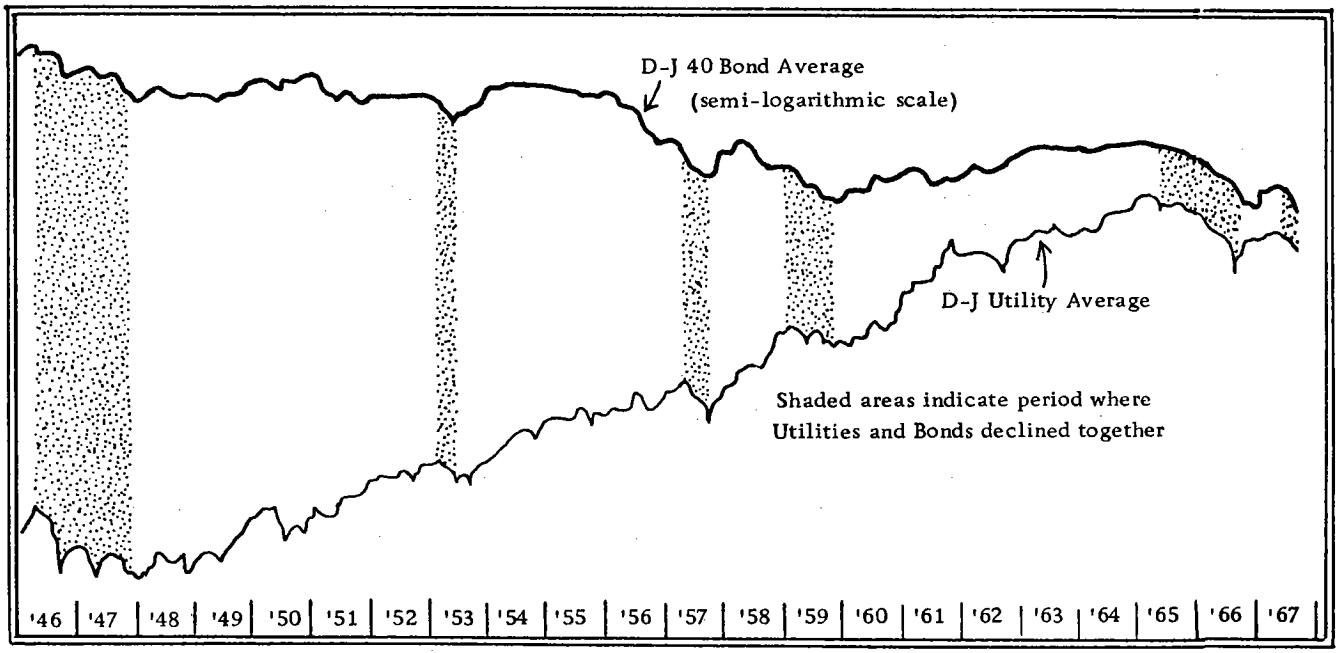
Subscribers should remember that almost every primary bear market ultimately produces crash-type action. Although the primary trend originally turned bearish on February 7, 1966, we have yet to witness panic or crash action in this bear market. I rather expect that such action may occur during the September-November period of this year. Going back over history, chaotic collapses occurred in the fall of 1929, 1937 and 1946, while lesser cave-ins came in the fall of 1957 and 1966. This bear market has yet to leave its mark on history in the form of crash headlines. Such headlines could lie ahead.

On the chart of the market (page 1) we note that the average price (30-week moving average) for the Industrials over the past 30-weeks is at about 875. I would consider any decisive drop by the Dow below the 875 level to be the beginning of the end for the entire structure which has been built up since late-1966. A breaking of the 875 level would indicate that informed investors were selling investment-grade Dow shares at prices below their average price of the past 30 weeks. This would constitute a most bearish technical situation, and, in my opinion, be comparable to untying the stem-knot on an inflated balloon.

I have taken particular care to study the 20 or so investment services which arrived here Monday. I note that only one is viewing the situation with genuine alarm. Those other services which have taken note of the deterioration in the markets are calling for a "secondary reaction" in a continuing bull market. Almost no one accepts the current picture as a serious one— as a topping out of a secondary reaction in a primary bear market. I consider this, in general, an ominous background to the Wall Street picture. Most of the major collapses of the past have occurred at a time when no one could foresee the possibility of danger. That environment is what we are witnessing today.

There is one interesting aspect to this whole situation which should be discussed. If we saw the rally top in August, if the market is now heading down generally to new lows, how will history view this whole confusing period? I am convinced that market historians ten or

twenty years from now will be of the opinion that we lived through a repeat of 1930, that the years 1966 and 1967 saw a great speculative correction accompanied by a major non-confirmation in that Rails pushed to historic highs unconfirmed by the Industrial Average. The fact that some of the other indices (S & P 425, S & P 500, the N.Y.S.E. Index and Barron's Low-Priced Stock Index) went to new highs will not, in my opinion, alter the verdict of market scribes. The history of the stock market has been written for 70 years in terms of the Dow Jones Averages, and I believe that it will continue to be written thus. Therefore, I feel that historians will call 1966 and 1967 a correction in a primary bear market. Time will be the final judge, of course.



BONDS AND UTILITIES: There are two ways of approaching the market. The first is through fundamentals, the second is via the technical. Throughout market history, whenever conditions in the money market were so poor as to drive both the D-J Utility Average and the D-J 40-Bond Average into a pronounced downtrend, the atmosphere for the market has been bearish. In other words, the whole monetary picture as reflected in Utilities and Bonds is so important that it also affects all other segments of the market.

From the technical standpoint, the accompanying chart (barring all rationales and explanations) shows six shaded areas wherein both the Utility and Bond Averages were declining. Each of these areas (for whatever reason) was also characterizes by lower prices in the rest of Wall Street.

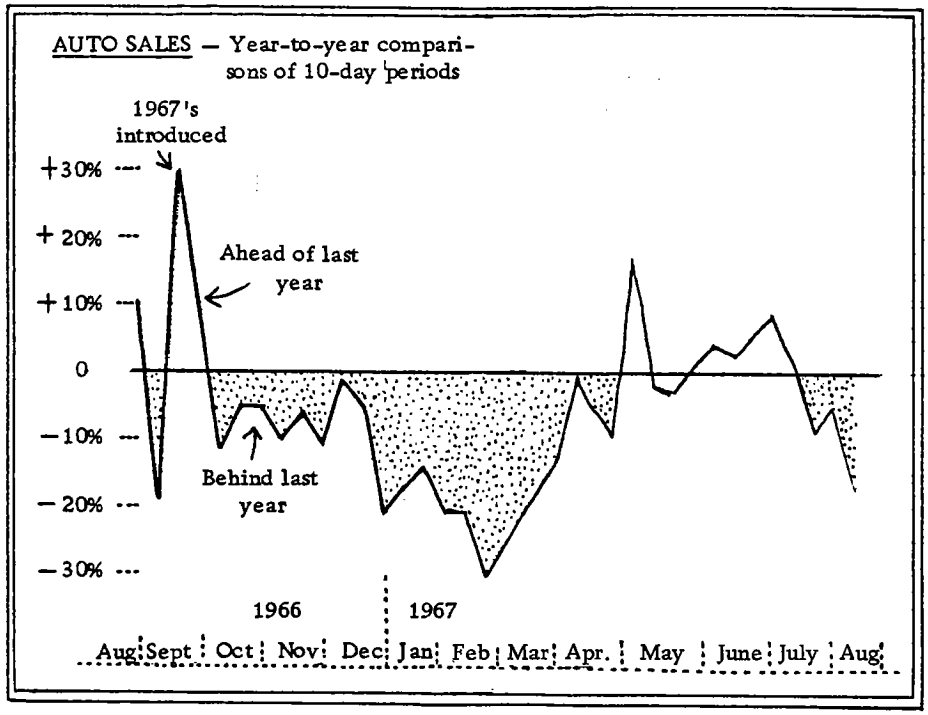
During the latest period the shaded area extended from early 1965 to mid-1966. This was the period during which most stocks caved in, and it corresponds to the first phase of the bear market. During the period from October, 1966 to May, 1967 either the Bond Average or the Utility Average (or both) rallied, thus taking the pressure off the market. The latest shaded or bearish portion of the chart extends from May-June, 1967 to the present. During this period the Utilities and Bonds headed down again, and late last week both of these indices succeeded in breaking to new lows for the year, thereby confirming the fact that they are in bona fide downtrends.

On a cold, technical reading of this chart, the climate for the stock market is now bearish. At no time in the past has the market been able to withstand such action on the part of the Utilities and Bonds.

I might add that this chart constitutes a valuable study of the D-J 40-Bond Index itself. For it covers the entire bear market in bonds, lasting from 1946 to the present. Note the steady decline from 1946 to 1959. This reflected continuing inflation and the natural forces of the market.

From 1959 to 1965 the bond market was under Government manipulation, and this resulted in the holding action of those years. But the forces of supply and demand will always overcome the manipulative forces, and on the chart we see the truth of this as the 40-Bonds finally break first below their 1959-60 lows (during 1966). This year, as the Government attempted almost anything this side of the law, the 40-Bonds broke below the 1966 lows again.

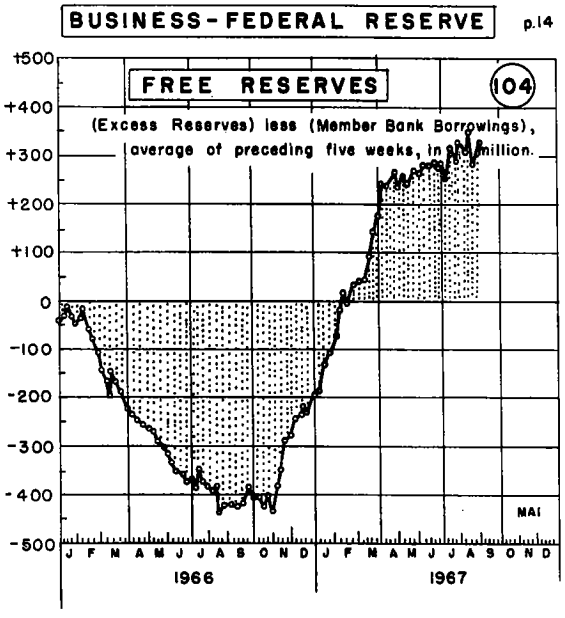
THE BIG ONE: The two biggest industries in the nation (excepting defense) are construction and autos. I have been particularly interested in the auto picture, and it should be remembered that autos employ, directly or indirectly, one out of every seven workers in the nation.



Although I receive the leading automotive publications, I find it particularly difficult to get a reading on just what the industry is doing. I have found a chart of the year-to-year comparisons (in percentages) of auto sales to be the best method of gauging action in the auto industry.

The accompanying chart traces the sales comparisons from late-1966 to date and it is based on the industry's famed 10-day sales periods. Despite propaganda to the contrary, the auto sales chart is not encouraging. Sales during most of 1966 and early 1967 lagged behind the preceding year's sales. During May-July, 1967, sales pushed slightly ahead of 1966, but since late-July sales have dropped below 1966 again. The latest period (second 10-days of August, 1967) saw sales slide 17% behind the comparable 1966 period. The excuse was lack of satisfactory choices due to broken inventories, but I am not impressed. The fact is that my chart does not bode well for auto profits, and on August 25 Ford announced that their earnings will drop 40% below the 1966 earnings. With costs rising, sales falling and a surtax on the way, I expect auto earnings to be even worse in 1968.

THE FLOOD: In an article entitled, "Dousing With Gasoline," the authoritative Weekly Bond Buyer (Aug. 28) notes that "The Federal Reserve has allowed bank credit to expand at a very rapid pace this year and, now, the inflationary embers are beginning to burn. But the Fed, in seeing the embers burn brighter as Congress dallies on a tax increase, has a problem: Tightening up on bank credit could mean substantially higher interest rates which would evoke problems for the commercial and savings bank systems and for interest rates themselves. Dousing the inflation embers is, indeed, a kind of dousing with gasoline. The choice of inflationary or deflationary fires is the Fed's dilemma."



The New Economists were, only a year ago, boasting about "fine tuning" the economy. The accompanying chart makes a mockery of this boast. When the Fed tried to cool off the economy in mid-1966, they produced minus reserves at the member banks and precipitated a near-panic in the money market. Realizing their error, they then flooded the market with money during 1967, but wonder of wonders, interest rates first eased, then started up again. As of now, interest rates are higher than the peak rates of 1966.

The Fed is now hoping. They are hoping that business will get going, but not so strong that inflation becomes a voter issue. They are hoping that if they ease on the money supply that interest rates will not go through the roof. They are hoping that Congress will enact some sort of surtax so that enough increased revenue will come in to keep the budget deficit from going into the wild blue yonder. They are hoping that a surtax will not dampen business severely. The "fine tuners" in the Government are now getting a full dose of their own medicine. It is going to take more than fine tuning to get this nation by the next year without major trouble. It is going to take a fantastic string of lucky circumstances. When that much luck is needed, the market usually sells off to the "safe" level. We can expect such action ahead.